

## Business Financing Factors Influencing Entrepreneurs' Decisions to Prepare a Business Plan

David Dearman, University of Arkansas at Little Rock

Joseph Bell, University of Arkansas at Little Rock

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*This paper investigates factors that influence entrepreneurs' decisions to prepare business plans. Data is obtained from a survey administered to clients of the Arkansas Small Business and Technology Development Center and designed to address various aspects of financing options, including availability/use of outside debt or equity funds and owner attitudes toward various funding options. Factors identified as influencing the decision to prepare a formal business plan in support of financing efforts include greater amount of required start-up costs, proportion of start-up costs raised from outside sources, and self-assessment of financial knowledge.*

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The business press often promotes the writing of a business plan as being indispensable for entrepreneurs' decision-making, but tends to do so without resorting to systematic empirical evidence. Clearly, the mere existence of a business plan does not justify making an inference as to its actual use or even its perceived usefulness. It may well be that two organizations both have a business plan, but that they use them in rather different ways, and consider them useful in different senses.

Furthermore, not having a plan may be beneficial in some way. For example, an entrepreneur that was previously employed in the industry may be assumed to be more informed about markets and industry practices than a person who was not previously employed in the industry. In such a case, writing a business plan may be particularly beneficial to a previously unemployed entrepreneur. Likewise, a novice entrepreneur may gain more benefit from writing a business plan than a serial entrepreneur. In a different sense, a portfolio entrepreneur facing the challenge of juggling the complexity of the simultaneous involvement in different ventures may feel that the presence of written business plans helps to shift their focus from one venture to the next. So, there are good reasons to believe that the impact of business plans on venture performance may not be uniform across all entrepreneurial profiles and contexts.

The added complication is that the propensity of entrepreneurs to select to write a business plan may itself be influenced by the profile of the new venture and its business context. A venture which contains people with plenty of relevant experience may feel that writing a business plan is a costly use of time. By contrast, an entrepreneur that knows little about the market and with 'lower' entrepreneurial capabilities may feel that the paper exercise of writing a business plan is both informative and instructive. It is, therefore, likely that, due to selection effects, the profile and context of ventures with business plans will vary systematically from those without plans. The issue is that it is easy to confuse the impact of business plans on performance with differences in performance due to selection effects.

The contribution of this paper is to identify those types of selection effects related to business financing that impact the entrepreneurial decision as to whether to prepare a business plan in support of efforts to obtain funding. The second section reviews the literature and develops hypotheses related to factors influencing the preparation of business plans. The third section describes the research method employed for this study, the fourth section presents results, and the final section discusses implications of these results and makes recommendations for future research.

### LITERATURE REVIEW

Planning has always been regarded as a cornerstone of management (Gulick, 1937; Fayol, 1949; Koontz and O'Donnell, 1955). At the same time, there has been considerable debate in the management literature about the actual merits that planning activities bring for organizations. While some studies have documented a positive impact of the extent of planning on performance, others have cast doubt at the existence of such a causal relationship (Pearce, et al., 1987; Boyd, 1991; Greenley, 1994). The question

concerning the value of planning has also been addressed in the entrepreneurship literature (see Gruber, 2007 for a recent review).

A primary role of planning is to allow organizations and individuals to respond proactively to opportunities and threats presented by their uncertain environments (Anshoff, 1979; Chakravarthy, 1987; Hax and Majluf, 1990).

In new ventures just starting up, plans may be of particular relevance, since these companies do not yet have much experience which they could use as a substitute for planning. Alternatively, one may argue that sophisticated planning practices are less relevant in new ventures, given that these companies often operate in dynamic environments which demand quick action rather than extensive deliberation. The entrepreneurship literature is divided about the relative merits of planning activities, with some authors stressing the possible benefits of planning (e.g. Block and MacMillan, 1985; Matthews and Scott, 1995; Shane and Delmar, 2004) and others warning against excessive planning (e.g. Bird, 1988; Carter et al., 1996; Allinson et al., 2000).

Furthermore, surprisingly little is known about the ways in which business plans are actually used in new ventures and to what extent they are considered useful by the entrepreneurs and managers themselves. In quantitative studies, business planning is often treated as a “black box” and approximated with often crude measures. While such an approach may be instructive for understanding broad patterns concerning the existence of a business plan, its level of detail, or the frequency of its modification, such an approach leaves somewhat unexplored the dynamics of business planning and the details of how and why plans are actually used (see Gartner and Birley, 2002). For example, it has been demonstrated in a primitive entrepreneurial setting that the demand for planning arises from the need for control; that is, plans provide the basis for performance measures that promote accountability for results (Gstraunthaler and Hendry, 2011).

Business plans are a prevalent feature of new venture management and are encouraged by government agencies, education institutions, and consultants. They are frequently a core requirement when seeking financial support. There is also a widespread belief that writing a business plan will impact favorably on venture performance. For example, Bygrave and Zacharakis (2004) argue that the development of an entrepreneurial idea alongside a sound execution strategy are the key means through which writing a business plan can enhance the performance of a new venture. They point out that most business plans require entrepreneurs to address various questions and employ analytical management techniques. This process allows entrepreneurs to develop and test their business strategy and subject it to market research (Gruber, 2007). And so, it is argued that business plans stimulate faster and better decision making because entrepreneurs can test their assumptions before expending valuable resources.

In contrast, Honig (2008) and Honig and Karlsson (2004) question if written business plans are anything more than mimetic devices that, at best, serve to legitimate the new venture. Indeed, formal business planning by the small business sector has been characterized as unwarranted (Gibson and Cassar, 2005), yet recognizing that while planning does not necessarily lead to high performance, high performers are likely to use planning. Also, Bhidé (2000) suggests that the impact of business plans on new venture performance is unlikely to have a generically positive, negative, or negligible effect. Instead, he posits that the efficacy of business plans is governed by the context within which business plans are written. Some are written to raise loan finance with the purpose of reassuring lenders of the low risk and secure positive cash flow position of the venture; others are written to help a founding self-funded entrepreneur devise a market entry and growth strategy for a high risk innovative new product in an emerging uncertain market. The effects on performance are unlikely to always be the same in such widely varying contexts.

Thus, the efficacy of written business plans may be context specific: potentially likely to have a positive impact in more predictable, stable markets but less so in more uncertain markets where entrepreneurs are introducing highly innovative products and services (Bhidé 2000). This discussion suggests that contexts and venture profiles influence the amount of information available to an entrepreneur and how a business plan might help increase this influence.

Capital acquisition is one of the most important and challenging issues facing small firms (Ang, 1992). Key specific contexts related to the initial financing requirements for the business operations include amount of initial investment required to begin operations of the business and the percent of start-up funds obtained from outsiders. As the required investment increases, especially investment obtained from outside sources, the pressure to justify and safeguard that investment through formal planning processes is likely to increase.

H1: Preparation of business plans will be positively associated with initial investment.

H2: Preparation of business plans will be positively associated with the proportion of outside investment.

Other contextual considerations expected to impact the formal planning decision involve the likely sources of personal financial contribution by the owner(s) at start-up, sources of outside financing (including both debt and equity capital sources), the projected sufficiency of start-up funds, and extent of investor involvement in the activities of the business. Small businesses rely on private capital markets, while larger firms are financed through public markets. Information on small businesses is much less readily available than information on larger firms, thus the private capital markets are characterized by complex contracts managed by specialized financial intermediaries (Berger and Udell 1998). In contrast, bootstrap capital can complement or reduce dependence on traditional sources of capital, allowing firms to leverage assets through informal arrangements (Ebben and Johnson, 2006; Van Auken, 2003; Bhidé, 1992). It is likely that those businesses with greater reliance on more formal financial arrangements will be more likely to prepare a business plan in support of those financing efforts than those businesses that arrange for financing using less formal bootstrapping arrangements. However, there is no expectation that the formal arrangements associated with debt financing will result in different formal planning frequencies than equity financing.

H3: Preparation of business plans will be positively associated with the formality of financing arrangements.

H4: The incidence of business plan preparation associated with debt financing will not be different from that associated with equity financing.

In addition, owner knowledge of financial issues and the nature of financial advice given to the owner may have an impact on the extent of formal planning that is undertaken. A recent study to delineate capital budgeting processes in small firms noted that a majority of small business owners did not have financial expertise due to their educational background (Danielson and Scott, 2006). Furthermore, there is some consensus that cognitive processes play a critical role in social behavior and thought (Bandura, 2001; Krueger, 2005). The role of perceived self-efficacy, an individual's judgment of their capability to attain a designated type of performance, is such that it mediates the relationship between knowledge and human action (Bandura 1986). Whereas high entrepreneurial self-efficacy produces strong probabilities of entrepreneurial activity (McGee et al. 2009), it is expected that perceived level of financial knowledge by the entrepreneur is related to their efforts to execute formal financial planning.

H5: Preparation of business plans will be positively associated with the self-assessment of financial knowledge.

## Method

A survey was administered by email to small business entrepreneurs identified and selected from the client pool of the Arkansas Small Business and Technology Development Center (ASBTDC), which provides a broad variety of consulting services to different client groups, from entrepreneurs in the planning stage to small companies that have been in business for many years. The survey population

included 1,303 going-concern companies that had been in operation for at least two years, having valid email addresses and receiving any type of counseling services from the center.

Three sets of email messages prepared by the researchers were sent by ASBTDC to the selected survey population. The first message was sent a week before the survey was available to potential respondents; the second message was sent when the survey became available and requested that the clients complete the survey; and the third message was sent the following week as a reminder that the survey was on-line and available for responses.

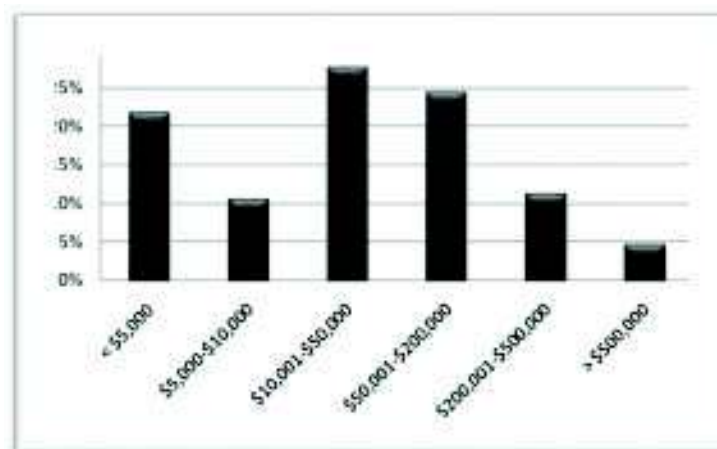
As required by Institutional Review Board guidelines, potential survey respondents were assured of confidentiality and anonymity, noting that participation was strictly voluntary. No incentives were offered by the researchers or ASBTDC for participation in the survey. The researchers are unaware of the identities of the respondents and are not personally involved with any respondents to this study.

Survey respondents were asked to complete a 28-item survey instrument. In addition to asking questions about the use of a business plan, the survey instrument was designed to address various aspects of financing within small businesses including the availability and use of outside debt or equity funds and owner attitudes toward various funding options. Specific question topics included founders' ownership and allocation of equity within the firm, owners' knowledge level concerning business financing, owners' financial contributions to the business startup, the nature and extent of external funding for the firm, current capital structure, owners' attitudes toward funding options (both previously employed and potential future options), the purposes for previously received debt and equity funding, and plans for raising additional capital.

## Results

A total of 162 survey responses were collected from the 1303 survey population, resulting in a 12.4% response rate. Business plans were prepared for 103 of the 162 businesses represented (64%). Respondents included 89 males, 66 females, and 7 individuals who did not indicate gender. There was with no significant difference between gender with regard to the decision as to whether to prepare a business plan ( $\chi^2 = 0.261$ ,  $p = 0.609$ ,  $df = 1$ ). In addition, there were 79 businesses with one founder, 59 with two founders, 13 with three founders, and 11 with four or more founders (mean = 1.8, median = 2). This result is generally consistent with a recent national survey in which small business firms had an average of three owners with a median of one (Mach and Wolken, 2006).

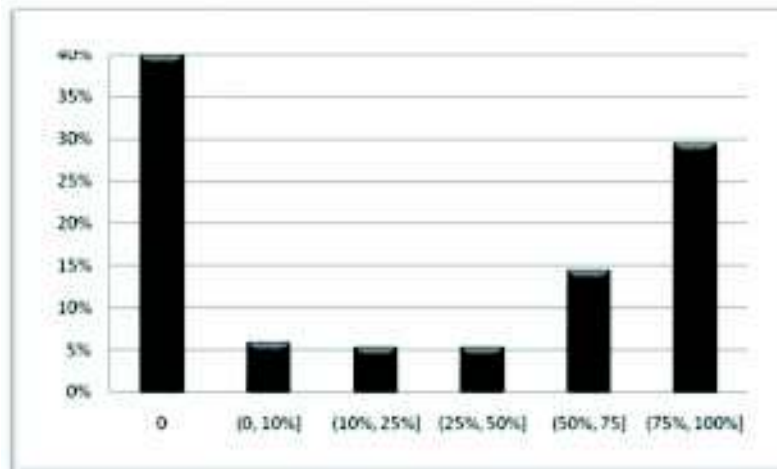
Figure 1: Initial Cost of Investment



The dollar amount of start-up costs was one factor related to the decision to prepare a business plan (see Figure 1). The sample mean for initial start-up costs was \$114 thousand with standard deviation of \$140 thousand. This variation is indicative of a wide range of operating costs associated with different types of businesses. Consistent with H1, business plan preparation is associated with the amount of start-

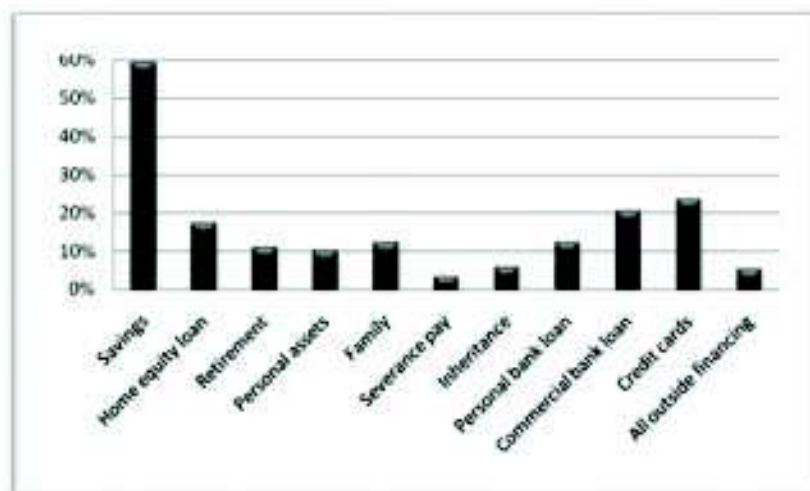
up costs ( $\chi^2 = 13.613$ ,  $p = 0.034$ ,  $df = 6$ ). In the smallest two groups 29 of 50 (58%) entrepreneurs prepared a business plan, whereas only 21 of 24 (88%) prepared a business plan in the largest two groups.

**Figure 2: Percent of Startup Cost Obtained from Outsiders**



With regard to the question concerning the percent of total start-up finances received from outside sources, results shown in Figure 2 (mean = 35.8%) are consistent with similar results reported by Cassar (2003) (mean = 40.2%). However, the observed relationship with business plan preparation is marginally significant ( $\chi^2 = 11.915$ ,  $p = 0.064$ ,  $df = 6$ ). While 43 of 70 respondents in the two lowest categories prepared business plans, 57 of 75 (76%) in the top three categories did. Thus, H2 is marginally supported.

**Figure 3: Sources of Personal Financial Contribution at Start-up**



The overwhelming majority of respondents (97%) reported that they used at least some of their own funds in the start-up phase. As shown in Figure 3, ninety-three (57%) provided funds from savings, while 27 (17%) provided money from home equity, 17 (10%) used monies from sale of personal assets, and 16 (10%) provided money from retirement accounts. However, direct financing through banks and/or credit cards is still one of the most important sources (31.2%) of business funding. Yet, no one factor or categorical combinations of factors are significantly associated with preparation of a business plan; significance levels of the individual Chi-square analyses range from 0.378 to 0.948. Thus, H3 is not supported.

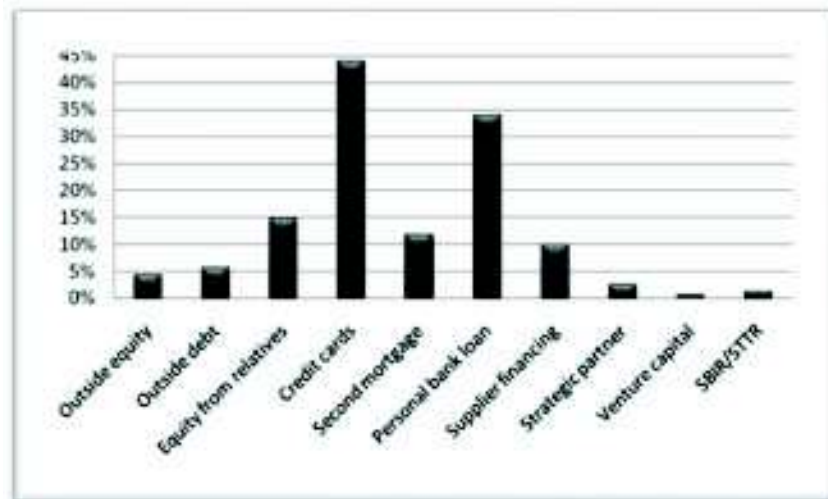
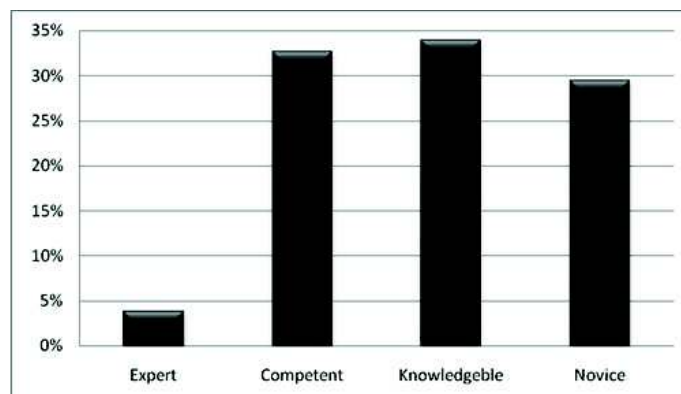
**Figure 4: Sources of Outside Financing**

Figure 4 summarizes responses to a question about types of financing received over the life of the business, not just at start up. Similar to the findings presented in Figure 3, credit cards and bank loans are the primary sources of on-going financing. However, the likelihood of preparing a business plan for entrepreneurs obtaining financing with equity-based financing from outsiders, relatives, or venture capitalists was marginally different from that of entrepreneurs obtaining debt financing from the various debt sources listed ( $\chi^2 = 6.305$ ,  $p = 0.098$ ,  $df = 3$ ), based on the summary data presented in Table 1, which summarizes the number of respondents obtaining debt financing, equity financing, both types, or neither at some time over the life of the business at or after start up. The majority of respondents obtained debt financing only and had the lowest incidence of business plan preparation, while the highest incidence of business plan preparation was observed for respondents who either obtained both debt and equity financing or neither type of financing. Thus, H4 presented as a null hypothesis is marginally rejected, not with regard to a difference between debt and equity financing but with regard to the combination of both or the lack of both.

**Table 1: Outside Financing: Debt vs. Equity**

	Debt	Equity	Both	Neither	Total
Plan	53	20	20	16	109
No Plan	35	10	5	3	53
Total	88	30	25	19	162
Plan %	60%	67%	83%	84%	67%

**Figure 5: Owners' Financial Expertise at Start-up**

Respondents were asked to reflect upon and rate their level of financial knowledge before they attempted to acquire money to start their business. As summarized in Figure 5 in the previous page, while 30% of the respondents rated themselves as “Novice”, a majority considered that they had some more advanced level of financial expertise and 4% evaluated their knowledge at the expert level.

**Table 2: Outside Financing: Debt vs. Equity**

	Expert	Comp	Know	Novice	Total
Plan	6	29	41	33	109
No Plan	0	22	12	19	53
Total	88	30	25	19	162
Plan %	100%	57%	77%	63%	67%

The pattern of business plan preparation, summarized in Table 2, indicates significant differences in knowledge level for those who develop plans and those who do not ( $\chi^2 = 8.222$ ,  $p = 0.042$ ,  $df = 3$ ), although the differences were not strictly linear. While the self-professed experts unanimously prepared business plans, those who considered themselves knowledgeable, but not competent was the second highest category of planners.

### Conclusion and Recommendations

The contribution of this paper is to identify those types of selection or contextual effects that impact the entrepreneurial decision as to whether to prepare a business plan in support of efforts to obtain funding. The results reported above provide insights into a dynamic and complex process related to the development of business plans by entrepreneurs. Although the amount of financing required to start a business is significantly related to the incidence of formal planning, there is no clear relationship between the decision to prepare a business plan and the type of financing sought at or subsequent to start up. The fact that the highest incidence of formal planning occurred either when both types of financing were sought or when neither was sought indicates that a significant motivation for investing the time and effort into formal planning processes related only to magnitude of finances required, not type of financing sought.

Furthermore, one or more factors unrelated to outside financing considerations seem to effect the decision to prepare a business plan. This latter result is consistent with prior studies that suggest entrepreneurs utilize the planning process as a learning experience, and further suggest that the resulting learning accomplished in the process is achieved with varying degrees of success.

Future research should investigate the psychological dynamics related to planning and related management control processes. Of particular interest would be various business contexts and entrepreneurial profiles that mediate or moderate the positive effects of planning on organizational performance.

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**David Dearman** is associate professor of accounting at University of Arkansas at Little Rock. He received his Ph.D. in accounting from University of Memphis. His primary research interests include judgment and decision making in management accounting. He has published in *Journal of Management Accounting Research*, *Contemporary Accounting Research*, *Journal of Ethics and Behavior*, and others.

**Joseph Bell** is an associate professor of entrepreneurship at University of Arkansas at Little Rock. He received his MBA at Michigan State University and a J.D. from Thomas M. Cooley Law School. His current research interests include early-stage fundraising, entrepreneurship course work, issues affecting entrepreneurial businesses, and case writing. He has published in *Entrepreneurship Theory and Practice*, *Entrepreneurial Executive*, *New England Journal of Entrepreneurship*, and others.